Effective: May 3, 1993

COORDINATED ISSUE
SHIPPING INDUSTRY
FEDERAL INCOME TAX WITHHOLDING ON WAGES
PAID TO U.S. CREW BY A FOREIGN TRANSPORTATION SHIPPING ENTITY

ISSUE:

Whether under IRC section 3402, (INCOME TAX COLLECTED AT SOURCE), wages paid by a foreign transportation shipping entity to U.S. seamen crew employees aboard its vessels, should be withheld and reported on Form 941?

FACTS:

The taxpayers are principally corporations organized in a foreign country, which operate a trade or business in the United States and have a permanent establishment in the United States. They are engaged in the international transportation of cargo or passengers for hire by a water transportation vessel, flagged in a foreign country. The ships typically sail around the world, transporting cargo and/or passengers. Some of the shipping entities sail between the U.S. and a foreign port, while some sail foreign port to foreign port. Some foreign flagged ships operate "cruises to nowhere" which embark and disembark from the same U.S. port.

The ship's U.S. crew is typically paid weekly in cash, in international waters. The crew member signs the weekly payroll voucher, acknowledging the receipt of his compensation. The employer does not make any accounting of the employee's yearly earnings. Additionally, the employer does not issue any Form W–2's and/or 1099's to the Internal Revenue Service indicating the yearly earnings of the employee and the amount of the Federal Income Tax Withheld. Additionally, the employer shipping entity has not obtained an "SSN" from their respective employees. Typically, the employer has filed Forms 941 for their shore side personnel.

LAW:

Section 3401, Definitions & Section 3402, Income Tax Collect At Source:

Under section 3402(a)(1), every employer making a payment of wages (as defined in section 3401(a)) is required to withhold federal income taxes as provided in the regulations. Section 3401(d) defines an "employer" generally as any person for whom an individual performs or performed any service, of whatever nature, as the employee

of such person. An employer includes a foreign corporation (or other entity) engaged in a U.S. trade or business. Section 3401(a) defines "wages" generally as remuneration for services performed by an employee for his employer with certain exceptions, including for certain services performed outside the U.S.

Employee/Employer Relationship General Rules:

Income tax withholding under section 3402(a) applies to wages paid to an individual who is an employee, with certain exceptions. Determination as to who is an employee made under common law principles. Treas. Reg. 31.3401(c)–1(b) provides that an employment relationship generally exists "when the person for whom the services are performed has the right to control and direct the individual, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished." The cases of T.L. Bishop v. U.S., 476 F.2d 977 (5th Cir. 1973), Cert. denied, 414 U.S. 911 (1973) and Mayport Fisheries Co, v. U.S., 476 F.2d 981 (5th Cir. 1973) have held that seaman are employees of the ship owner (ship operator) and not the ship master.

Wages Paid to U.S. Crew Citizens and Resident Aliens:

The U.S. crew members are employees of foreign shipping cargo, cruise line operating entities, or of the vessel owning companies. The remuneration paid to U.S. crew members who are U.S. citizens or resident aliens (including nonresident aliens who have elected to be taxed as resident aliens under section 6013(g) or (h)) would be wages for purposes of section 3401(a). These wages would generally not be excepted under section 3401(a)(8), which excludes from the term "wages" remuneration paid to U.S. citizens that is reasonably anticipated to be exempt from tax under Section 911 or remuneration paid for services performed in a foreign country or a U.S. possession with respect to which wage withholding is required under foreign law. Unless U.S. citizen seaman can establish that they are a resident of a foreign country and their seaman wages are subject to taxation in that resident foreign country, they are not eligible to exclude their income from withholding under section 911. For reasons discussed below, an exemption based upon section 911 would not be available with respect to U.S. citizen crew members, unless they can establish their presence or residence in a foreign country independent of their presence on a foreign flag ship. Section 911 exception is available only to U.S. citizens and not to U.S. resident aliens.

Inapplicability of the Section 911 Exception:

Benefits under section 911 are conditioned upon the taxpayer being present or residing

in a foreign country. A ship employee's presence or residence aboard a ship does not qualify as presence or residence in a foreign country for purposes of section 911 even though the ship is of a foreign registry or is in international waters. The regulations have consistently defined the term "foreign country" as " any territory under the sovereignty of a government other than that of the United States." See Treas. Reg. section 1.911–2(h). It includes the territorial waters of the foreign country as determined in accordance with the laws of the United States. In Revenue Ruling 67–52, 1967–1 C.B. 186, cited in L.R. Martin, 50 T.C. 59 (1968), the Service ruled that the Antarctica region is not under the sovereignty of any government and, therefore, is not considered a foreign country for purposes of section 911. Also, in Revenue Ruling 73–181, 1973–1 C.B. 347, the Service ruled that physical presence on a fishing boat in international waters, adjacent to the territorial waters of a foreign country, does not satisfy the presence requirement of Section 911(d)(2). In Souza, 33 T.C. 817 (1960), the court held that a U.S. registered fishing vessel operating off the coast of Peru beyond the 3 mile territorial waters limit but within the 200 mile limit recognized by Peru as its territorial waters does not constitute presence in a foreign country for purposes of section 911. The court ruled, the fact that a vessel is of U.S. or foreign registry should have no effect on the determination of whether its crews members are present or resident in a foreign country. Consequently, the high seas and Antarctica are not considered a foreign country for purposes of section 911. See also, Balestries, 47 BTA 241.

Applicability of Section 530 of the Revenue Act of 1978:

Congress enacted section 530 of the Revenue Act of 1978 as a relief measure for employers to avoid heavy assessments for failing to properly comply with federal employment taxes, i.e., social security taxes and federal income tax withholding. Specifically, section 530 provides relief to employers who fail to treat their workers as employees but have a reasonable basis for treating them as independent contractors. This "interim", but not permanent, solution was intended to give Congress time to resolve the complex problem of defining who is an employee. Section 530 was made permanent under section 269 of TEFRA, and applies to all taxable years beginning after December 31, 1978 until such time as Congress enacts legislation as to the classification of workers as independent contractors or employees.

Under section 530, if the Service determines that the workers were improperly treated as independent contractors, the employer may obtain relief if the employer has been consistent in treating the workers as independent contractors and timely issued all appropriate forms, i.e. Forms 1099's. Late filing of the relevant Form 1099's (e.g., in connection with an audit of the relevant years) would not constitute compliance with the filing requirement. If, however, these two conditions are met, then the employer must show he had a reasonable basis for treating the workers as independent contractors.

Section 530 did not change the status of the worker as a common law employee. Thus, the worker is considered an employee for all other purposes of the Code.

Liability for Tax:

Treas. Reg. 31.3403–1 (Liability for Tax) provides that every employer is required to deduct and withhold the tax under section 3402(a) from the wages of an employee who is liable for the payment of such tax whether or not it is collected from the employee by the employer. If the employer deducts less than the correct amount of tax or fails to deduct any part of the tax, the employer is nevertheless liable for the correct amount of the tax. Federal income tax withholding tax assessments may be adjusted under section 3402(d), to the extent of the amount of tax paid by the employee. However, the employer is not relieved of any penalties or additions to the tax for failure to pay over amounts as withholding, including the 100% penalty under section 6672, Failure To Collect And Pay Over Tax, or section 7201 Attempt To Evade Or Defeat Tax.

Section, 3509; Determination Of Employer's Liability For Certain Employment Taxes:

Under section 3509 , (effective September 3, 1982), if the failure to withhold income taxes is due to reclassification by the Service of a worker as an employee, the maximum amount of tax that may be assessed is 1.5 percent of the relevant wages as defined in Section 3401 (or 3 percent where the employer has also failed to file the appropriate Form 1099 information returns).

Section 3509 relief is available only with respect to reclassification cases. Prop. Treas. Reg. 31.3509–1((a) and (b)(2) under section 3509 provide that the section applies if the failure is due to the treatment of an employee as not being an employee for purposes of Chapter 24, based on the employer's belief that the worker was not an employee. Thus, where failure to withhold the tax required under section 3402(a) is due to reasons other than the treatment as independent contractors, section 3509 would not apply.

Section 3509, also does not apply where the failure to withhold is due to the taxpayer's intentional disregard of the requirements to deduct and withhold the tax, per section 3509(c).

It is important to understand that relief under section 530 or Code section 3509 is available only with regard to situations involving the misclassification of workers as independent contractors. These provisions do not apply with regard to "wage" issues. In any event, in view of the Supreme Courts' decision in United states v. Webb, 397 U.S. 179 (1969), 1970–1 C.B. 194, concluding that seaman are employees for federal employment tax purposes, it seems unlikely that an employer could be entitled to

section 530 relief under other than on the basis of a "prior audit." Thus, relief under section 3509 would also be unavailable.

BACK–UP WITHHOLDING:

A 20 percent back–up withholding is imposed under section 3406 with respect to a reportable payment, generally where the payee has failed to furnish a taxpayer identification number (TIN) to the payor. The payor may be liable for the amount which should have been back–up withheld if it has failed to secure the TIN from a payee to whom it makes a reportable payment and back–up withholding is required. The back–up withholding tax provisions are effective with respect to payments after December 31, 1983.

A reportable payment is defined in section 3405(b). In the case of wages or other remuneration for personal services, a reportable payment includes only a payment that is required to be shown on a return under section 6041 (relating to information returns at source) or section 6041A (relating to information returns concerning payments of remuneration for services).

Section 1.6041–3 of the regulations provides that information returns are not required under section 6041 with respect to payments of income required to be reported on Forms W–2. All wages subject to income tax withholding under section 3402(a)(1) are required to be reported on a Form W–2. See Regulations section 1.6041–2. Further, regulations section 1.6041A–1(d)(2) provides that no return is required under section 6041A with respect to a payment that is exempted under section 1.6041–3 from reporting requirements of section 6041. Thus, no back–up withholding applies with respect to wages paid to crew members who are U.S. citizens or resident aliens attributable to their services performed, to the extent such crew members are employees and not independent contractors. Also, an exemption from the back–up withholding tax is provided in section 3406(g)(2) which provides that the tax does not apply to any amount for which withholding is otherwise required under Title 26 of the Code.

Amounts paid to individuals who are independent contractors may be subject to information reporting under section 6041 and, thus, to back–up withholding under section 3406. Thus, if the taxpayer successfully argues that its crew members are independent contractors, but did not comply with the information reporting and back–up withholding requirements, it is exposed to additions to taxes and to the penalties that may be imposed on payors that failed to comply with their obligations under sections 6041 or 3406.

A penalty would be imposed on the taxpayer under section 6721(a) for the failure to file

an information return. The penalty is $50 for each failure, not to exceed $100,000 for any calendar year. Also, a payor that fails to back–up withhold under section 3406 may be assessed the 20 percent backup withholding tax under code section 3403 and regulation section 31.3403–1.

COMPUTATION OF WITHHOLDING TAX:

The Income Tax Withholding used by the employer may be either the Percentage Method, Wage Bracket Method or an Alternative Method of Income Tax Withholding as explained, Department of the Treasury, Internal Revenue Service "Circular E" Employer's Tax Guide. The rate of withholding is variable depending upon, martial status, number of exemptions and the frequency of the wage compensation payment.

SUMMARY:

U.S. seamen wages (are subject to withholding per IRC section 3402(a)(1)) paid by foreign shipping entities, which operate a trade or business within the U.S. and have a permanent establishment. The employer is to maintain an accounting of all compensation paid to his respective employees for the calendar year, indicating the total compensation paid and the amount of Federal Income Tax Withheld. The employer will withhold the Federal Income Tax and report the amounts on the employer's quarterly Form 941 Tax return. Additionally, the employer will furnish the employee by January 31 of the following year, with a Form W–2, indicating the amount of the employees annual gross income and the amount of tax withheld.